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Tax Tips for Forest Landowners for the 2014 Tax Year

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Tax laws on timber transactions are very specialized knowledge that are not commonly known. Yet they are important to timber owners in terms of the ongoing cost of owning and managing timber, forest stewardship and compliance to the tax law. This bulletin reviews the major federal income tax laws to help forest owners in filing their 2014 income tax returns. The information presented here is current as of September 30, 2014.

Timber Property

There are three basic types of timber ownerships: investment, business or personal-use property. The tax rules vary considerably with each classification. For each tax year, you must determine your woodland property's tax classification based on your purpose of ownership, your use and activities on the property.

Timber property held for an *income-producing* purpose may be an investment; it may rise to a business if you regularly and continuously engage in the timber activity to make a profit. Legal entities such as LLC, sole proprietor, partnership, corporation (S or C corporations), estate or trust may own the property. It is a good practice to document your profit motive in a written forest management plan. You must *materially participate* in a business in order to avoid the restrictions on loss deductions (*passive loss rules)*. If your primary purpose of owning the property is personal use (vs. profit making), the property is personal use property, which is subject to limitations on deductions.

Example 1: A woodland owner grows timber for profit and documents the income production in her forest management plan. She claims the property as investment property and deduct qualified expenses on Schedule A (subject to 2 percent adjusted gross income limitation). (As a contrast, expenses are fully deductible for materially participating business owners.)

Timber Basis and Depletion

Timber basis may be deducted from timber sales, which reduces the tax due on the sales. If you purchased the timber property, the timber basis is the amount you paid for it. If you inherited the property, the basis of timber is its fair market value (FMV) on the decedent's date of death. If you receive the timber as a gift, the timber basis is the lower of its FMV or the donor's basis.

Example 2: You inherited forest land on June 1, 2010. Your consulting forester gave you a professional estimate on the fair market value of the timber on June 1, 2010. The timber was valued to be $32,000 ($27,000 pine sawtimber, $3,000 pine pulpwood, and $2,000 hardwood pulpwood), which is your timber basis.

If you didn't establish the basis at the time of acquisition, a consulting forester can determine it retroactively, but you should weigh the cost of doing so against the potential tax savings.

Dividing your timber basis by the total volume of timber gives you the *depletion unit*, multiplying it by the units of timber sold gives you the depletion amount.

Example 3: You sold 300 MBF of sawtimber, out of a total of 1,000 MBF on your property, for $250 per MBF. The total basis of your 1,000 MBF of sawtimber was $40,000. The depletion unit is therefore $40 ($40,000 / 1,000 MBF) and the depletion is $12,000 ($40 / MBF x 300 MBF). You can deduct $12,000 from your sale proceeds $75,000 ($250 / MBF x 300 MBF).

Timber Sales

Sale of standing timber. Sale of investment timber "on the stump" generally is taxed as capital gains. If you hold the investment timber for more than 1 year before the sale, the sale qualifies for long-term capital gain, which is taxed at advantageous lower tax rates than ordinary income. Sale of inherited timber is considered long-term. Report the sale of standing timber held as an investment on Form 8949 and Schedule D.

To be eligible for long-term capital gains (Sec. 1231 gains) for sale of timber held in business, you must own the timber for more than 1 year in the business. Both outright sales and pay-as-cut sales of standing timber by a timber business qualify after the timber has been held for more than 1 year. Report the sale of standing timber held for business use on Form 4797 and Schedule D. If you sell timber outright in a business, you also are required to file Form T unless you only have an occasional timber sale (see below).

Example 4: You sold your standing timber that you inherited for $9,000. The timber is an investment property for you. You paid $1,900 in hiring a consulting forester and legal fees (writing the sale contract). Assuming a depletion deduction of $1,330, your net long-term capital gain is $5,770 ($9,000 – $1,900 – $1,330).

Sale of products cut from timber held for use in a business. If you cut your own timber or have it cut by a contractor working at your direction, either for sale or for use in your business, the gains are ordinary income unless you elect to use sec. 631(a) on Form T, Part II.

Example 5: You paid a contractor $2,000 to cut standing timber held for *business use* for over 1 year into logs and sold the cut logs to a mill for $30,000. The FMV of the standing timber was $23,000 on Jan. 1 and your basis in it was $1,000. If you elect to use sec. 631(a) on Form T, report a $22,000 long-term capital gain ($23,000 – $1,000) on Form 4797 and Schedule D, and $5,000 of ordinary income ($30,000 – $23,000 – $2,000) on Schedule C. If you fail to make the election, all $27,000 is ordinary income.

On top of the capital gain tax, for taxpayers meeting income threshold, an additional **3.8 percent tax** on net investment income applies to investment timber sales and passive business timber sales, effective January 1, 2013. This 3.8 percent tax, enacted as part of the 2010 healthcare reform law, applies *only* to single taxpayers with adjusted gross income ("AGI") over $200,000 or couples with over $250,000 AGI.

Example 6*:* You sold your investment timber for a gain of $30,000. Your adjusted gross income is $230,000 and file as single taxpayer. Because your income is above the $200,000 individual threshold, the $30,000 capital gains are subject to the 3.8 percent tax, in addition to the long-term capital gain tax.

Installment Sales

An installment sale involves receiving one or more payments after the year of sale, allowing you to defer tax by spreading your gain over 2 or more years. Interest is charged on deferred payments.

Example 7: You sold timber for $10,000 ($8,000 after deducting timber depletion and sale expenses) in 2013. The buyer paid you $5,000 in 2013 and will pay the remaining $5,000, plus interest, in 2014. Your *gross profit percentage* is 80 percent ($8,000 ÷ $10,000). Report a $4,000 gain for 2013 ($5,000 x 80%), using Form 6252.

Timber Management Expenses

If you hold your forest land to grow timber for profit, you can deduct ordinary and necessary timber management expenses, such as the cost to protect the timber from insects, disease or fire, control brush, do a precommercial thinning or mid-rotation fertilization, or maintain firebreaks. If you qualify as an investor, deduct these expenses on Schedule A, where they are subject to a 2% of adjusted gross income reduction; if you qualify as a material participant in a business, deduct them on Schedule C.

Reforestation Costs

All taxpayers except trusts may deduct up to $10,000 ($5,000 for married couples filing separately) per year of reforestation costs per *qualified timber property* (QTP). Qualifying costs include the direct costs to establish or reestablish a stand of timber by planting, seeding, or natural regeneration. Any amount over $10,000 per year per QTP may be deducted over 84 months (*amortized*).

Example 8: You spent $17,000 to reforest after a harvest. Deduct $10,000, plus 1/14th of the remaining $7,000 ($500) on your 2014 tax return. Deduct 1/7th of the $7,000 ($1,000) on your returns for 2015–2020 and the last 1/14th ($500) on your 2021 return. If you qualify as an investor, take the $10,000 deduction as an adjustment to gross income on the front of Form 1040; if you hold your forest land for business use, take it on Schedule C. Elect to amortize and take amortization deductions on Form 4562, Part VI.

Depreciation and Sec. 179 Expensing

You may depreciate capital expenditures, such as for logging equipment, bridges, culverts, fences, temporary roads, or the surfaces of permanent roads over a set number of years. For example light-duty trucks and logging equipment are depreciated over 5 years. If you hold your forest land for business use, you may expense up to $500,000 in qualifying property (generally tangible personal property) in 2014, subject to a $2 million phase-out and business taxable income limitation (*sec. 179 expensing*). In addition, a 50-percent additional depreciation deduction is allowed for qualified property ("bonus depreciation") in 2014.

Cost-share Payments on Form 1099-G

If you receive a cost-share payment from a qualified government program, you may exclude part or all of the payment from your income if the cost share is used in capital expenditure. Qualified federal programs include the Forest Health Protection Program (for southern pine beetle and mountain pine beetle), Conservation Reserve Program, Environmental Quality Incentives Program, Wildlife Habitat Incentives Program, and Wetlands Reserve Program (discontinued Feb. 7, 2014). Several state programs also qualify for exclusion. The excludable amount is the *present value* of the greater of $2.50 per acre or 10 percent of the average annual income from the affected acres over the last 3 years. You cannot exclude part or all of a cost-share payment from your income and also claim a deduction for the expense reimbursed by the payment.

Example 9: You received a $3,900 cost-share payment from the Conservation Reserve Program and used it as capital expenditure for your 100-acre woodland. If you had no income from the property in the last 3 years, you could exclude up to $4,725 (($2.50 x 100 acres) ÷ 5.29%). The interest rate is from the Farm Credit System Bank. If you had $6,600 of income from the property, you could exclude the entire payment: (10% x ($6,600 ÷ 3)) ÷ 5.29% = $4,158 > $4,000. Attach a statement to your tax return describing the program and your calculations.

Timber Casualty and Theft Losses

Loss of timber from a casualty—a sudden, unexpected, and unusual event such as a fire or severe storm—may be deductible from your taxes. The deduction is the *lesser* of the decrease in FMV caused by the casualty or your basis in the timber block (the area you use to keep track of your basis). Similarly, a theft loss deduction is limited to the *lesser* of the decrease in FMV or your basis in the stolen timber. A competent appraisal usually is required.

Filing Form T (Timber)

You must file Form T (Timber), *Forest Activities Schedule*, if you claim a timber depletion deduction, sell cut products in a business (under sec. 631(a)), or sell outright timber held for business use. There is an exception for owners who only have an occasional timber sale, defined as one or two sales every 3 or 4 years.

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